R5650-2

JAPAN · ECONOMIC · INSTITUTE

JEI

REPORT

A Two-Part Report: A and B

NO. 43A

November 10, 1989

STRUCTURAL CHANGES IN JAPAN'S DISTRIBUTION SYSTEM

Summary

Japan's distribution system, once regarded as politically sacrosanct, now is under siege. The United States perceives the distribution system as a major obstacle to increased imports and has placed the issue at the top of its agenda in the Structural Impediment Initiative talks. In addition to the United States, European Community countries have urged the Japanese government to grapple with this problem to ease trade frictions and eventually reduce trade imbalances. Responding to this criticism as well as pressure for change at home, the Japanese government has begun to consider how to reform the distribution system and related business practices and government regulations.

Significant changes in lifestyles and consumption patterns already are affecting the distribution system. Whether these shifts and the increasing emphasis on a service-oriented economy will propel politicians and the bureaucracy to facilitate the modernization of the system remains to be seen. In particular, the government will be looking at the close ties between manufacturers and retailers and how this affects imports. The country also is hearing calls for repeal of or at least changes in the Large Retail Store Law. However, the consumerism that blossomed in the late 1980s is unlikely to end, and that development has spin-off effects for the distribution system, including the potential for modernization.

Overview of the Distribution Sector

Japan's distribution system is characterized as an inefficient and multilayered structure made up of numerous small retail and wholesale stores.

Japan had just over 1.6 million retail stores and nearly 437,000 wholesale establishments as of 1988. These figures were not so different from the numbers for the United States, which in 1982 (the latest year for which census data are available) had 1.5 million-plus retail outlets and about 416,000 wholesale establishments, but they were four or more times higher than the equivalent numbers for the United Kingdom, France and West Germany (see Table 1). When the population difference between Japan and the United States is taken into account, however, Japan -- with nearly half the population of the United States crammed into an area roughly the size of California -- had about 132 retail stores and 36 wholesale establishments per 10,000 people, twice as high as the comparable U.S. figures.

Table 1: International Comparison of Retail and Wholesale Businesses

	Japan (1988)	United States (1982)	United Kingdom (1982)	France (1982)	West Germany (1985)
Number of Retail Stores (thousands)	1,620	1,542	343	472	407
Number of Wholesale Establishments (thousands)	437	416	95	78	119
Number of Retail Stores per 10,000 People	132	66	61	87	67
Number of Wholesale Establishments per 10,000 People	36	18	17	14	19
Number of Retail Stores per Wholesale Establishment	3.7	3.7	3.6	6.1	3.4

Source: Adapted from Ministry of International Trade and Industry, Vision of the Distribution Industry in the 1990s, June 1989.

The average number of employees per retail outlet was 4.2 in 1988 in Japan, much smaller than the 1982 U.S. figure of 6.4. Another indication of the small size of Japanese retail operations is that stores with one to nine employees represented 93.3 percent of all outlets last year compared with a figure of 80.5 percent for the United States in 1982. Japan, however, is not unique in this regard. France's retail network also is characterized by a multiplicity of small, primarily mom-and-pop, outlets (see Tables 2 and 3).

A good indicator of whether a country's distribution system is multilayered is the ratio of wholesale to retail sales. Japan's 1988 figure of 3.89, although slightly overstated because of the unique distribution role of trading

The JEI REPORT (ISSN 0744-6489) is published weekly except for the New Year, Memorial Day, Labor Day, Thanksgiving and Christmas holiday weeks for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI REPORT, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

Table 2: International Comparison of Employees per Retail Store

	Japan (1988)	United States (1982)	France (1982)	West Germany (1985)
Number of Employees (thousands)	6,851	12,846	1,627	1,931
Number of Employees per Store	4.2	6.4	4.2	13.6

Source: Adapted from Economic Planning Agency, Seventh Report of Study Group on Distribution, March 1989.

Table 3: International Comparison of Size of Retail Stores

Number of Employees	Japan (1988)	United States (1982)	France (1982)	West Germany (1985)
1-2	54.0%	40.0%	66.7%	14.7%
3-9	39.3	40.5	30.1	62.8
10-19	4.3	10.4	1.9	14.7
20-49	1.9	6.5	1.0	5.7
50-99	0.3	1.9	0.2	1.2
100 and Over	0.1	0.7	0.2	0.9

Source: Adapted from Economic Planning Agency, Seventh Report of Study Group on Distribution, March 1989.

companies (sogo shosha), stands out from that of its major trading partners: 2.08 in the United States (1982), 2.03 in the United Kingdom (1982), 1.57 in France (1982) and 1.67 in West Germany (1979). A comparative look at relative productivity also highlights the fact that Japan's distribution sector has a long way to go to catch up with its efficient manufacturing sector, not to mention other countries. In 1985 the relative productivity of the Japanese distribution system was 59.4 percent (manufacturing productivity counted as 100) versus 67.8 percent for the United States, 71.1 percent for France and 78.4 percent for West Germany.

Changes in the 1980s

Once Japan's distribution system was regarded as stable, an unchanged structure over time. But now it is undergoing dramatic, rapid change. Between World War II and 1982 the number of retail stores increased at a stable 1 to 2 percent a year. At the peak in 1982 there were more than 1.7 million shops; by 1988 that number had decreased 5.9 percent to just over 1.6 million. Most of this reduction came from the rapid decline in the number of mom-and-pop stores (see Table 4). In 1982 60.2 percent of all shops or 1 million-plus had one or two employees; six years later the figure was 54 percent or 874,330, a drop of 15.6 percent. This decline was accompanied by increased numbers in all other size categories; for example, stores with 10 to 19 employees jumped 30.3

Table 4: Size Structure of Japan's Distribution Sector

Retail Industry

Number of Employees	1982 Outlets Number	1982 Outlets Share	1985 Outlets Number	1985 Outlets Share	1988 Outlets Number	1988 Outlets Share
1-2	1,036,000	60.2%	940,000	57.7%	874,330	54.0%
3-4	413,000	24.0	408,000	25.0	422,025	26.1
5-9	188,000	10.9	190,000	11.7	213,999	13.2
10-19	54,000	3.1	58,000	3.6	70,382	4.3
20-29	15,000	0.9	15,000	0.9	19,183	1.2
30-49	9,500	0.6	10,000	0.6	12,249	0.8
50-99	4,500	0.3	4,800	0.3	5,361	0.3
100+	1,900	0.1	2,000	0.1	2,070	0.1
Total	1,721,465	100.0	1,628,644	100.0	1,619,599	100.0

Wholesale Industry

Number of Employees	1982 Establishments Number	1982 Establishments Share	1985 Establishments Number	1985 Establishments Share	1988 Establishments Number	1988 Establishments Share
1-2	100,000	23.3%	93,000	22.5%	95,340	21.8%
3-4	108,000	25.2	105,000	25.4	110,109	25.2
5-9	120,000	28.0	115,000	27.8	121,646	27.9
10-19	61,000	14.2	59,000	14.3	64,689	14.8
20-29	18,000	4.2	18,000	4.4	20,078	4.6
30-49	13,000	3.0	12,000	2.9	13,898	3.2
50-99	7,000	1.6	6,900	1.7	7,786	1.8
100+	2,800	0.7	2,700	0.7	2,956	0.7
Total	428,858	100.0	413,016	100.0	436,502	100.0

Source: Ministry of International Trade and Industry, Census of Commerce.

percent to 70,382 last year. At the same time, the proportion of retail stores owned and operated by individuals, which peaked at 79.4 percent in 1976, has fallen by a significant margin and, similarly, the share of sales generated by these sole proprietors has dropped considerably from 1976's all-time high of 29.8 percent.

Another sign of the changing structure of Japan's distribution system is the rapid spread of convenience stores, such as 7-11, and discount outlets and the growth of mail-order businesses. Among the increased numbers of two-income families or women working part-time in urban areas, the time available to go shopping for daily needs is limited. Convenience stores, with their longer business hours -- often open 24 hours in many areas of central Tokyo -- and broader choice of products from food and cosmetics to magazines, are more attractive to busy consumers than ordinary small retail stores. As they have gained in popularity, some convenience stores have started to offer rental videos, fast delivery of small parcels (takkyu-bin) and liquor. Since a convenience store with a liquor section is regarded as the most competitive, it is no surprise that industry leader 7-11 is eagerly expanding its liquor business.

Discount consumer electronics outlets, a rather new business, also are popping up in major cities. By buying large quantities of goods from a primary wholesaler, these stores skip the multilayered distribution network and can sell products at deeply discounted prices. Contrary to accepted Japanese practice, there usually is no delivery, no wrapping, no insurance, no installment payment plan, no explanation of how to use the item and sometimes no products on display. Since these shops sell televisions, stereos and similar products for 10 to 20 percent below normal prices, they are very crowded with young people.

The mail-order business, too, is prospering because it saves shopping time and offers a wide choice of merchandise. According to the white paper on small and medium-sized businesses drafted by the Ministry of International Trade and Industry, the leading reason given for choosing a shopping place 10 years ago was a store's proximity to home rather than price. However, more and more consumers now say the ability to buy various goods at one time and at low prices ranks equally as high as proximity. The rapid increase in convenience stores and other nontraditional outlets reflects a change both in consumer behavior and in lifestyles.

Table 5 underscores the changing structure of Japan's retail sector, even allowing for some double-counting, for example between franchise chains and convenience stores. A report by Nikkei Ryutuu Shinbun showed similarly big gains for the new retail channels in FY 1987, including 17.5 percent for convenience stores, 12.2 percent for discount stores and 18.1 percent for mail-order businesses.

Table 5: Changes in Sales by Different Types of Retail Businesses in Japan

	Average Annual Growth Rate 1982-85	Average Annual Growth Rate 1985-88
Department Stores	3.7%	6.2%
Shopping Centers	6.5	4.4
Voluntary Chains	7.0	7.5
Franchise Chains	4.9	14.7
Convenience Stores	15.8	---
Discount Appliance Outlets	12.5	14.9
Mail Order Businesses	9.1	17.7
Total Sales	2.7	4.1

Note: Some retail services appear in more than one category.

Source: Ministry of International Trade and Industry, Vision of the Distribution Industry in the 1990s, June 1989.

Business Practices in Japan

Despite American perceptions, Japanese retail and wholesale practices are not all that different from those in the United States. Key elements of

commercial success include high product quality, low prices, quick delivery and full repair services. If the conventional wisdom were right, for example, the distribution sector would not have undergone the structural changes of the past few years, and Japanese consumers most likely would have many more complaints about the retail industry. Having said that, the fact remains that at least three business practices are unique to Japan's distribution system.

For certain goods retailers are able to return merchandise to wholesalers to allow new product displays or a change in seasonal products or simply to get rid of unsold products. According to the Japan Chamber of Commerce and Industry, this product return system allows retailers to avoid the risk of not selling items and makes it easier for manufacturers to get their goods displayed in stores and to market new products. While this approach distributes sales risks over the entire system, the related administrative costs drive up the overall costs of doing business and, in turn, retail prices. Since this system does not apply to imported products, retailers have a disincentive to handle foreign merchandise.

The product return system is an outgrowth of the historically weaker economic status of retail stores compared with relatively large wholesalers and manufacturers. The upstream part of the chain protected the interests of small retail stores by sharing sales risks. However, recent trends in the retail end of business -- the upsurge of convenience and other nontraditional stores and the decline in the number of mom-and-pop shops -- suggest that the product return policy will be less important in the future, with the result that retailers will have more leeway to decide prices and how to handle goods on their own.

Also unique to the Japanese distribution system are the transactions among companies that are part of the same corporate group or keiretsu. Retailers often are affiliated with manufacturers in such industries as motor vehicles, home appliances and consumer electronics, and cosmetics. It is said that manufacturers of consumer goods encouraged this system as an effective way to expand their business in the era of double-digit economic growth in the 1960s and early 1970s. There is no prima facie evidence that transactions among group members violate antitrust statutes, although these dealings admittedly are exclusionary to some extent. Retailer competition among keiretsu is strong as the groups attempt to get a higher market share. As such, many in Japan's business community believe that the possibility of antitrust violations should be reviewed on a case-by-case basis. Still, it is undeniable that the existence of the keiretsu makes it difficult for foreign manufacturers to compete and thereby limits the expansion of imports.

Another criticism stemming from the linkage between manufacturers and retailers in a keiretsu focuses on manufacturers' suggested prices and a complex system of rebates. Manufacturers frequently suggest a price to retail stores in a bid to ward off cutthroat competition. Strengthening this system is a complex rebate mechanism. Economists who suspect this process of freezing out distributors of competitive products suggest that the Antimonopoly Law be applied strictly to protect the consumer's interest and that keiretsu activity be monitored closely.

A third unique aspect of Japan's distribution network is the system of sole import agents, which in the past worked effectively to encourage imports.

Historically, foreign-made products were introduced to the market as highly prestigious, expensive items. Thus, the sole import agent and the overseas producer tended to keep prices high to maintain the image of the imported good and to make as much money as possible. This pricing strategy is not illegal by itself, but if the sole import agent does anything to restrict competition, this could be construed as a violation of the antitrust law. (A current, related investigation involves Apple Computer Japan Inc. and its sales agent, Canon Sales Co., Ltd. For details see JEI Report No. 39B, October 13, 1989.) As parallel imports -- brand-name products obtained overseas independent of foreign manufacturers' sole agents in Japan -- increase, there is a growing possibility that the sole import agent system will become less of an obstacle to expanded imports.

Much work has been done, both by the government and economists, on how to improve the distribution system and how to correct restrictive business practices. The goal seems to be to promote price competition by fostering the independence of retailers, in large part by freeing them of the pressure from domestic and foreign manufacturers to keep prices high. In this sense, antitrust enforcement is critically important for promoting imports as well as protecting the consumer's interest.

Government Regulation: Large Retail Store Law

The Large Retail Store Law, called Daitenhou in Japanese, was not intended to stymie the opening of department stores and supermarkets but rather to provide for a smooth adjustment of the interests between big retailers and surrounding small retailers. However, application of the law has proved different. From the standpoint of protecting the interests of small retailers, the law is very effective since it provides a way to significantly delay a large store's opening.

According to Article 5 of the Large Retail Store Law, the owner or the operator of a proposed store with a sales floor space of more than 1,500 square meters (16,146 square feet) must submit an application to the Ministry of International Trade and Industry at least five months before the planned opening; a company interested in opening a store with a selling area between 500 square meters (5,382 square feet) and 1,500 square meters is subject to the same requirement but the application goes to the prefectural government. If the planned store is part of a mall or similar shopping complex, the project's general contractor must submit an application to either MITI or the prefectural government (Article 3), depending on the size of the store, before the store files its application.

After the application is filed, the ministry or prefectural government must convey the relevant information, including the store's name, location, opening day, shopping space and hours of operating, to the retailers around the proposed site. A large store cannot open during the seven months following the filing of the Article 3 application since the authorities use this time to investigate and review the impact of the planned store on the local economy. The review includes an effort to determine the future sales of neighboring small stores based on the projected impact of the new outlet. If officials anticipate that the planned store will have a major impact, they can recommend that the owner delay opening or decrease the selling space. This determination must be made within four months of the receipt of the application from the owner.

Applications by stores with more than 1,500 square meters of selling space also are reviewed by the Council on Large-Scale Retail Stores, while plans for stores up to this threshold are examined by counterpart councils at the prefectural level. The councils hear the views of local chambers of commerce and the Council for Coordinating Commercial Activity, which consists of the local chamber of commerce, consumers and scholars. Having gathered their recommendations, the councils advise the authorities responsible for clearing the new store.

If the Large Retail Store Law were implemented as intended when it was enacted in 1974, any big store could open seven months after an Article 3 application had been filed since the interests of the new retailer and existing small retailers would have been reconciled. At the time of the law's enactment the adjustment process was expected to take a year or two. However, while the average period from the planning stage to the opening of a large store was four to five years 10 years ago, it now runs seven to eight years; in some instances the process takes 15 years.

The Large Retail Store Law initially applied only to stores with a sales floor space over 1,500 square meters. When department store and supermarket chains began to open stores all over the country with a selling area below this threshold, local governments drafted regulations on medium-sized stores. Bowing to this pressure in 1979, MITI extended the reach of the law to stores with a shopping area of 500 square meters. But this change did not resolve the conflicts between local governments, which were being lobbied by local merchants for tighter controls on the expansion plans of big retailers, and MITI. Finally in 1982 the ministry issued new guidelines governing the size of stores that could be opened in cities of varying population and beefed up the consultative role of localities on the opening of big retail operations. MITI also started to use administrative guidance to slow the spread of supermarket chains.

Despite MITI's attempts both to strengthen the Large Retail Store Law and tighten its implementation, many local government units remained dissatisfied. Currently, 20 of the 47 prefectures have stronger regulations than MITI's, while 233 municipal governments have their own versions. Generally, shops over 200 or 300 square meters (2,153 or 3,229 square feet) are subject to local regulation. In the extreme case, however, even the smallest store can come under scrutiny if it is owned by people from outside the area.

Local interest groups have distorted implementation of the Large Retail Store Law from the beginning. The law provides that the Council on Large-Scale Retail Stores be only an advisory organization to coordinate interests between a major store and small stores. This council, in turn, must take into account the voice of the Council for Coordinating Commercial Activity, but under MITI guidelines CCCA has just three weeks to come up with a recommendation. Since this process did not give local merchants enough time to thwart the opening of big stores, they created an informal organization called a pre-CCCA and eventually succeeded in carving out a pivotal role for this new body.

As the system works now the owner or the operator of a planned large store must gain a pre-CCCA's approval for such things as the size of the selling space and business hours before it files a formal Article 5 application. During these negotiations the pre-CCCA has the upper hand because there are no time limits on its activities. And this is not the only roadblock since small retailers also came up with another informal group -- a pre-pre-CCCA -- that

must be consulted before a general contractor can file an Article 3 application. The operations of both the pre-CCCA and the pre-pre-CCCA lack transparency, and this gives them the power to indefinitely delay a store's opening. Many department store and supermarket chains consider the two groups' actions to be illegal harassment.

With pressure for change building at home and abroad, a MITI advisory panel recommended in early June that the Large Retail Store Law should be applied more flexibly to get back to its original intent. Among the proposed changes are:

- The first notice of a proposed business complex, given before an Article 3 application is filed by the general contractor, simply should present the necessary information about the planned project. This is an attempt to limit the influence of the pre-pre-CCCAs, which have used this notification step to extract concessions.

- The review period for pre-CCCAs should be limited to eight months. If agreement cannot be reached within that period, the review should be transferred to the CCCA itself or to the Council on Large-Scale Retail Stores.

- Regulations covering business hours, the number of days a year a store is closed and related matters should be relaxed.

- Overly strict local regulations should be revised in line with the Large Retail Store Law.

MITI, however, is unable to begin implementing these suggested changes because of pressure from Liberal Democratic Party members worried about losing the political support of small retailers. Already nervous about losses the ruling party suffered in the July upper house elections, they fear they could lose their seats in the coming lower house elections if they endorse MITI's reforms.

In some business circles it is argued that the Large Retail Store Law is outdated and should be abolished immediately. But the consensus is that the proposed changes in implementation would be a good first step and that more flexibility can be expected in the future. External pressures also are being brought. U.S. agencies, such as the Office of the U.S. Trade Representative and the Commerce Department, maintain that the proposed steps are inadequate and that the Large Retail Store Law must be repealed to help increase imports (see JEI Report No. 24B, June 23, 1989). If the LDP fails to satisfy the United States, the Structural Impediments Initiative talks could be in jeopardy and Japan's distribution system possibly could be taken up within the framework of the Super 301 provision of the 1988 Omnibus Trade and Competitiveness Act.

It is unclear how MITI, caught between the conflicting demands of the LDP and the United States, will resolve its dilemma. What is sure, however, is that how Tokyo handles problems related to the Large Retail Store Law and whether it is prepared to strictly enforce the Antimonopoly Law will be regarded overseas as the first test of Japanese willingness to address structural reform and to coordinate its economic policies with those of other industrialized countries.

For further information, contact Hideo Takahashi.

APPENDIX

Distribution Sector Indicators, 1982, 1985 and 1988

	1982	1985	1988
Retail Industry			
Number of Outlets	1,721,465	1,628,644	1,619,599
Retail Outlet/Wholesale Establishment Ratio	4.01	3.94	3.71
Number of Employees	6,369,000	6,329,000	6,850,478
Number of Employees per Outlet	3.7	3.9	4.2
Population per Retail Employee	18.6	19.1	17.9
Annual Sales (million yen*)	Y93,971,000	Y101,719,000	Y114,829,000
Annual Sales per Outlet (thousand yen*)	Y54,588	Y62,456	Y70,900
Annual Sales per Employee (thousand yen*)	Y14,754	Y16,072	Y16,762
Selling Space (thousand square meters)	95,430	94,507	102,096
Annual Sales per Square Meter of Selling Space*	Y984,711	Y1,076,312	Y1,124,716
Per Capita Sales*	Y791,481	Y840,313	Y935,242
Sales/Inventory Ratio	9.4	10.3	9.8
Wholesale Industry			
Number of Establishments	428,858	413,016	436,502
Number of Employees	4,091,000	3,998,000	4,331,681
Number of Employees Per Establishment	9.5	9.7	9.9
Population per Wholesale Employee	29.0	30.3	28.3
Annual Sales (million yen*)	Y398,536,000	Y428,291,000	Y446,423,000
Annual Sales per Establishment (thousand yen*)	Y929,296	Y1,036,984	Y1,022,728
Annual Sales per Employee (thousand yen*)	Y97,418	Y107,126	Y103,052
Wholesale/Retail Turnover Ratio	4.24	4.21	3.89

*The following average annual exchange rates can be used to convert the yen figures: 1982, Y249.08; 1985, Y238.54; and 1988, Y128.15.

Source: Ministry of International Trade and Industry, Census of Commerce.

* * * * * *

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.